No. 16063

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

MONOLITH PORTLAND CEMENT COMPANY,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

UNITED STATES OF AMERICA,

Appellant,

vs.

MONOLITH PORTLAND CEMENT COMPANY,

Appellee.

On Appeals From the Judgment of the United States District Court for the Southern District of California.

APPELLANT MONOLITH'S REPLY BRIEF AND ITS ANSWER AS CROSS-APPELLEE.

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I.

QUESTIONS PRESENTED.

Following appellee's[1] numerous admissions and abandonment of points on appeal in its brief, only two questions are presented to this Court:

A. Whether taxpayer's depletion deduction should be computed on the sales price of its cement, by virtue of

---

[1]Although the appellee has filed a cross-appeal and is technically a cross-appellant, taxpayer will refer to it as "appellee" herein, or as the "Commissioner" whose acts are those complained of.

the clear and unambiguous statutory provisions in Section 114(b)(4)(B) of the Internal Revenue Code of 1939, laying down the simple, practical rule that "the term 'mining' as used herein shall be considered to include not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products", or whether it should be computed on a purely hypothetical value assigned to the limestone content of the finished cement by the Commissioner.

B. Whether taxpayer's depletion deduction should be computed as 15% of the selling price of its finished cement, by virtue of the statutory provision in Section 114(b)(4)(A)(iii) of the Internal Revenue Code of 1939, applying such rate to "chemical grade limestone," and taxpayer's proof that such term means a limestone suitable for any industrial chemical application, or whether it should be computed as 10% of such sales price of its cement allowed "calcium carbonates" under Section 114 (b)(4)(A)(ii), as a "miscellaneous" limestone usable for non-chemical purposes.

Since Question "A" above is the only question raised by appellee's cross-appeal, it will be discussed first. Taxpayer will then reply to appellee's answer to taxpayer's presentation of Question "B" in its opening brief.

Other subsidiary questions, not essential to a decision, but of importance in insuring a proper compliance with this Court's mandate will also be discussed in their proper context.

II.

THE DISTRICT COURT PROPERLY HELD THAT THE DEPLETION DEDUCTION FOR LIMESTONE SHOULD BE COMPUTED AS A PERCENTAGE OF THE INCOME REALIZED FROM THE FINISHED BULK CEMENT.

A. The Statute Expressly Provides That "Mining" Shall Include the Ordinary Treatment Processes Normally Applied by Miners in Order to Obtain the Commercially Marketable Mineral Product or Products.

Section 23(m) of the Internal Revenue Code of 1939 allows a deduction for depletion in the computation of net income. Section 23(n) provides that the basis for such depletion "shall be as provided in section 114."

Subparagraph (A) of Section 114(b)(4) provides that in the case of certain mines and other natural deposits, including deposits of limestone, the deduction allowed by Section 23(m) "shall be" a percentage of "gross income from the property" subject to a limitation that such deduction cannot exceed 50% of the net income from the property.

Subparagraph (B) of the same section defines "gross income from the property" to mean "gross income from mining" and then defines "mining" as follows:

> "*The term 'mining'*, as used herein, shall be considered to *include* not merely the extraction of the ores or minerals from the ground but also *the ordinary treatment processes normally applied* by mine owners or operators *in order to obtain the commercially marketable mineral product* or products . . ." (Italics added.)

This statutory language is clear and unambiguous. Its obvious meaning is that gross income from mining must include the income from *all* processes which are normally applied to the ore or mineral in order to obtain "the commercially marketable mineral product or products," that is, the products obtained for which a commercial market exists.

This language has been held to be "clear and unambiguous" by four Courts of Appeal.

> *United States v. Cherokee Brick & Tile Company,* 218 F. 2d 424 (C. A. 5th, 1955);
>
> *Townsend v. The Hitchcock Corporation,* 232 F. 2d 444 (C. A. 4th, 1956);
>
> *United States v. Sapulpa Brick & Tile Corporation,* 239 F. 2d 694 (C. A. 10th, 1956);
>
> *Dragon Cement Company, Inc. v. United States,* 244 F. 2d 513 (C. A. 1st, 1957), cer. den. 355 U. S. 833 (1957).

This "clear and unambiguous" principle was recently reaffirmed by the Fifth Circuit in *United States v. Merry Brothers Brick & Tile Company,* 242 F. 2d 708 (C. A. 5th, 1957) (and the Supreme Court again denied certiorari. 355 U. S. 824 (1957)), which approved the law stated in *Cherokee* that (p. 709):

> "The statutory language is clear and unambiguous, which is that gross income from mining must include the income from ordinary treatment processes which must be applied to the ore or mineral in order to obtain the commercially marketable mineral product, that is, the first product which is marketable in commerce. There is no provision in the statute for excluding any process before such a marketable product is reached. The only restriction is that the processes must be the ordinary treatment processes normally applied by mine owners or operators."

B. Since There Is No Commercial Market for Monolith's Limestone Before It Is Processed Into Cement, Its Depletion Upon the Limestone Must Be Computed on the Selling Price of Its Cement.

The undisputed findings of fact are that there is no commercial market for Monolith's limestone before it is processed into cement [F. of F. X, R. 65], and that the first commercially marketable product is cement [F. of F. XI, R. 65].

The Government admits at page 11 of its Brief that:

> "The question whether the taxpayer's first commercially marketable mineral product was Portland cement or some lesser product is no longer in issue."

The undisputed findings of fact are also that *all* of the processes applied by the taxpayer to produce its cement were usual and customary steps applied in the cement industry to obtain cement. [F. of F. III, R. 63.]

The Government stipulated that *all* the steps or processes applied by the taxpayer to obtain cement are the usual and ordinary steps applied in the cement industry to obtain cement [R. 24].

It follows from these undisputed facts that Monolith's depletion deduction is to be computed on the selling price of its cement, since all of the processes which it applied to its limestone to obtain cement were ordinary treatment processes normally applied by mine owners or operators to obtain the commercially marketable mineral product.

C. The Illustrative Enumeration of "Ordinary Treatment Processes" in Section 114(b)(4)(B) Does Not in Any Way Modify or Change the Scope of the "Mining" of Plaintiff's Limestone.

The enumeration of certain processes as included in "ordinary treatment processes" in Section 114(b)(4)(B) do not modify or restrict the definition of "mining" as applied to plaintiff's limestone.

The enumerated process steps are not exclusive and complete, since the statute merely states that ordinary treatment processes *"shall include"* those enumerated. The illustrations are non-exclusive. As Section 3797(b) of the Internal Revenue Code of 1939 provides:

> "The terms 'includes' and 'including' when used in a definition contained in this title shall not be deemed to exclude other things otherwise within the meaning of the term defined."[2]

D. The Decision Below as to Computing the Percentage Depletion on the Commercially Marketable Product—Cement—Is Supported by All Courts of Appeal Decisions.

All Courts of Appeal which have considered the proper point at which to compute the percentage depletion deduction have held that the deduction was to be *computed on* the income from the "commercially marketable mineral

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[2]See also: *Gray v. Powell,* 314 U. S. 402, 416 (1941); *Federal Land Bank of St. Paul v. Bismarck Lumber Company,* 314 U. S. 95, 99-100 (1941); *Dragon Cement Company v. United States,* 244 F. 2d 513, 516 (C. A. 1st, 1957); *Townsend v. The Hitchcock Corporation,* 232 F. 2d 444, 447 (C. A. 4th, 1956).

product" resulting from the application of "ordinary treatment processes."

> *United States v. Cherokee Brick & Tile Co.*, 218 F. 2d 424 (C. A. 5th, 1955);
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> *United States v. Merry Brothers Brick & Tile Company*, 242 F. 2d 708 (C. A. 5th, 1957), cert. den., 355 U. S. 824 (1957);
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> *Townsend v. Hitchcock Corporation*, 232 F. 2d 444 (C. A. 4th, 1956);
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> *United States v. Sapulpa Brick & Tile Corporation*, 239 F. 2d 694 (C. A. 10, 1956);
>
> *Dragon Cement Co., Inc. v. United States*, 244 F. 2d 513 (C. A. 1st, 1957), cert. den., 355 U. S. 833 (1957).

As the Court said in the *Townsend* case (232 F. 2d 444, 447):

> " 'Congress clearly provided that the cost of obtaining a marketable product should come within the definition of mining and the same basis should be applied to gross sales. The only limitation by Congress is that the process must be that normally applied by the miner to obtain a marketable product. *It seems immaterial whether that process be one of manufacture as in the brick and tile case* (*supra*) (United States v. Cherokee Brick and Tile Co., 5 Cir., 218 F. 2d 424), *or some other step; that which was essential to obtain the first marketable products is an expense of mining* and the gross sales of the products so mined is the gross income from which the 15% depletion is to be taken.' " (Italics added.)

E. Congress Deliberately Adopted the "Commercially Marketable Product" as the Basis for Depletion to Provide a Simple, Practical Rule.

As a result of many disputes between the Commissioner and the mine owners over the percentage depletion deduction, Congress enacted, in Section 124(c) of the Revenue Act of 1943 (which became Sec. 114(b)(4)(B)), the statutory definition of "gross income from the property."

In explaining the new provision, the Committee stated:

> "The purpose of the provision is to make certain that the ordinary treatment processes which a mine operator would normally apply to obtain a marketable product should be considered as a part of the mining operation . . .
>
> "The law has never contained such a definition, and its absence has given rise to numerous disputes. *The definition here prescribed expresses the congressional intent of these provisions as first included in the law. . . .*" (Sen. Rep. 627, 78th Cong., 1st Sess., pp. 23, 24, 1944 C. B. 991.) (Italics added.)

Nevertheless, the Treasury did not yield to the mandate of Congress. When the Revenue Act of 1951 added a number of new minerals to the list of those entitled tc percentage depletion (including, for the first time, those used in the production of cement), the Treasury again attacked the commercially marketable mineral products rule. It wrote a "mining/manufacturing" theory into the regulations governing the computation of the allowance for certain of those minerals (including those used by the cement industry). This theory apparently represented the formalization of a point of view that had been basic to the Treasury's thinking in its pre-1943 efforts

to frustrate the commercially marketable mineral products test.

Objection to the re-introduction of this Congressionally disapproved doctrine soon appeared. A rash of litigation broke out. The Treasury's regulation was challenged in the courts by taxpayers in several industries. They argued that the regulation was invalid, since it was in clear conflict with the commercially marketable mineral products test. The litigation was strongly resisted by the Government. It culminated in a complete victory for the taxpayers. The courts of appeals for four federal circuits, without a single dissent, unanimously agreed that the "mining/manufacturing" argument of the Treasury was not compatible with the "clear and unambiguous" meaning of the statute. The Treasury's regulation was held invalid. In October of 1957, the Supreme Court announced that it would not review the issue, thus leaving undisturbed the decisions of the courts of appeals.[3]

The commercially marketable product rule adopted by Congress was a logical one, in view of the purpose to be accomplished. Congress sought to end numerous disputes, caused by the Treasury's attempt to whittle away at the depletion deduction.[4] Congress wanted a simple,

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[3]*Dragon Cement Company, Inc. v. United States*, 244 F. 2d 513 (1st Cir., 1957), *cert. den.* 355 U. S. 833 (1957); *United States v. Merry Brothers Brick & Tile Company et al.*, 242 F. 2d 708 (5th Cir., 1957), *cert. den.* 355 U. S. 824 (1957); *United States v. Cherokee Brick & Tile Co.*, 218 F. 2d 424 (5th Cir., 1955); *United States v. Sapulpa Brick & Tile Corp.*, 239 F. 2d 694 (10th Cir., 1956); *Townsend v. The Hitchcock Corp.*, 232 F. 2d 444 (4th Cir., 1956).

[4]Taxpayer has appended to this brief, as Appendix "A", a concise legislative history of percentage depletion and the "gross income from mining" which led to the enactment of Section 114(b)(4)(B), and its easily applied definition of "mining" as including "ordinary treatment processes."

practical, definite rule. Certainly the rule adopted was the best one for that purpose, since the cut-off point was directed to the marketable product whose market price could be easily ascertained and used as a basis for computing the deduction. As the District Court pointed out in *Cherokee Brick & Tile Company v. United States*, 122 Fed. Supp. 59 (affd., 218 F. 2d 424), at pages 63-64:

> "It is this Court's opinion that the 'first commercially marketable product test' was used because at no earlier stage would it be possible to determine just what would be the gross income from mining. If it be determined that mining includes processes (a) through (h) how could this Court compute the gross income from such operations, where the product at that stage had no market? It is true that the Commissioner by regulations has provided that in such cases the income from each process shall be considered as proportionate to costs. This is obviously a pure fiction which might be false more often than true. Evidently, it was to obviate the necessity of using such a fiction that Congress adopted the 'first commercially marketable product' test to determine what acts constitute mining."

Quite apart from the fact that gross income computed in this way "is obviously a pure fiction which might be false more often than true," the actual problem of allocating income and costs in this way is extraordinarily difficult. Some items, such as the cost of certain labor and repair parts (*i.e.*, direct costs), are clearly attributable to a given operation. Indirect costs are another matter altogether. They cannot be determined with accuracy and present complex accounting problems of allocation on which responsible members of the accounting profession differ. The possibilities of differences between revenue agents and taxpayers are obvious.

In short, were the appellee's argument adopted, a Pandora's Box would be opened, leading to yet another round of litigation before the taxpayers got the benefits intended by Congress.

F. The Appellee Argues That Although the Process of Adding Small Quantities of Other Materials to the Limestone Essential to the Production of Cement Is Admittedly an "Ordinary Treatment Process," the Income "Attributable" to the Added Materials Should Be Excluded When Computing the Depletion at the Commercially Marketable Product Stage.

1. The Appellee's "Additives" Argument Is Based on the Fallacious Assumption That the Depletion Deduction Is Allowed on the Commercially Marketable Product, Whereas, Such Depletion Is Actually Only Computed on Such Product.

Having deliberately stipulated below that the addition of essential raw materials to limestone to obtain the admitted "first commercially marketable product"—bulk Portland cement—is an "ordinary treatment process" [R. 24] the appellee repudiates its stipulation, and by an involved, exercise in applied semantics, attempts to justify its conduct. It is not an easy task.

Passing the fatal objections that such point is both untimely and may not now be urged, and that the issue is one of fact decided adversely to appellee below, based on undisputed, stipulated facts (Rule 52, F. R. C. P.), the argument is contrary to the clear, unambiguous statute, contrary to judicial authority, and contrary to the record facts.

The basic argument on "additives" is not related to the plain command of the statute, but rests, rather, upon the

theory or concept of depletion which the Commissioner contends is reasonable. Basically, the argument is that since it is "unsound" to calculate depletion on a "commercially marketable product" which contains small quantities of other essential materials in addition to the limestone, the income attributable to such process step of adding such materials should be excluded from the depletion base, although it must and has been conceded that such process is an "ordinary treatment process." (Br. pp. 11, 14, 17.)

The assumed rationale is that while the process which adds or "blends" such "additives" to the limestone in order to produce cement—"the commercially marketable product"—is an "ordinary treatment process," the "additives" are not, and unless excluded, some sort of double depletion will result. (We will pass for the moment, the incorrect assumption that "blending" cement raw materials is a mere mixing which effects no chemical or physical change.) The appellee's brief undertakes to confuse the issue by giving the impression that since the statute allows the depletion *for* the limestone, the percentage depletion must be calculated *on* the *limestone content* of the admittedly first "commercially marketable mineral product"—cement.

Nothing could be further from the truth. Percentage depletion is not allowed *on* any process, and is not allowed *on* any process step, *on* any product or *on* the contents thereof. On the contrary, depletion is allowed to compensate the mine owner *for* exhaustion of his natural deposit. Congress directed the deduction allowed for such exhaustion to be *computed* as a stated percentage of the selling price of the "commercially marketable product." It has done so by defining "gross income from the prop-

erty" in Section 114(b)(4)(B) to include not only the income derived from the extraction process but also the income from processes applied to the ore or mineral, after extraction from the natural deposit, to obtain the commercially marketable product. But in no sense does this mean that depletion is allowed *on* any of the processes, or *on* the products or the contents thereof, or that such processes, or products are depleted.

Appellee requests this Court to rewrite the statute—to go behind the statutory cut-off point of "commercially marketable product" fixed by Congress. The argument is based, not on statutory construction, or even legislative history, but on what the Commissioner desires.

2. Appellee's Argument Ignores the Obvious Fact That Congress Intended to Provide a Simple, Practical Rule Which Could Be Easily Applied to Compute the Percentage Depletion Deduction.

In order to compute a percentage depletion deduction, there must be a dollar base to which the applicable percentage must be applied. Congress elected to use the marketable product rule as a simple means to provide this dollar base. With this dollar base established in subparagraph (B) of Section 114(b)(4), Congress can then set the applicable rates in subparagraph (A) to produce the dollar amount of depletion which it wishes to grant in the case of each particular type of natural deposit without disturbing the simple means for determining the dollar base.

If Congress on further consideration should feel that applying the applicable rate to the gross income resulting from the sale of the commercially marketable product, produces too large a depletion deduction, or produces un-

desirable "double depletion," it has only to lower the rate, while still using as a base the gross income from the marketable product.

In spite of its effort to conceal the fact, the Government's argument essentially is merely that depletion calculated upon the marketable product is "unsound." However, this is a matter exclusively for Congress.

> *Lewyt Corp. v. Commissioner,* 349 U. S. 237, 99 L. Ed. 1029 (1955);
>
> *Helvering v. Wood,* 309 U. S. 344, 347, 84 L. Ed. 796 (1940).

The Government, therefore, realizing that it cannot ask this Court to change the percentage rates specified in the statute, seeks instead to have this Court rewrite the statute by changing the dollar base to which the rate is applied, as it has unsuccessfully urged in a variety of arguments in other cases in the several Circuits.

The Government argues that as to the "additives" purchased by Monolith, other taxpayers who mined such materials "presumably have claimed the statutory depletion allowance and (they) cannot be depleted" by Monolith "who had no economic interest in their production." (Br. p. 16.) It also argues that the "additives" mined by Monolith "If . . . depletable at all . . . are depletable at whatever percentage rates are provided as to each" and not as part of the depletion computed on the basis of Monolith's admittedly first "commercially marketable mineral product"—bulk Portland cement. (Br. p. 16.)

Of course, Monolith is not claiming a depletion allowance on materials purchased from others, or on its own mined "additives" used in producing the first "commer-

cially marketable mineral product"—bulk Portland cement. Monolith is claiming a deduction for depletion only on its natural deposit of limestone. It is because the bulk Portland cement is the "commercially marketable mineral product" obtained from such limestone, that the statute requires that the selling price of the bulk cement be used as the basis for *measuring* the *allowance*. This in no way means that Monolith is taking a depletion allowance on its purchased additives or mined additives as such. The Government confuses the *allowance* of the deduction for depletion with the *statutory method for computing* it. Upon the slightest reflection, counsel could not fail to recognize that at whatever stage of processing "the commercially marketable product" is reached, processes involving depreciation and other costs involving tax allowances have been used in bringing it to that stage. Counsel must know not only that the statute requires, but that the Commissioner's universal practice is to allow, depletion computed on the full value of the commercially marketable product, and also to allow as deductions from gross income the depreciation and other tax allowances involved in the costs of bringing the product to that stage. Nor can counsel be ignorant of the fact that in many other cases (litigated and settled) the Commissioner has allowed the inclusion of additives necessary to combine with the basic raw material (here limetone) to produce the first commercially marketable product. (*E.g.*, see *Northwest Magnesite Co. v. United States*, 58-1 U. S. T. C., par. 9394.)

In summary, Congress was not concerned with the refinements of semantics when it enacted Section 114(b)(4)(B). It was concerned only with whether a commercial market exists for a particular product to pro-

vide a convenient or starting point for *computing* the depletion deduction. Any cost and every cost necessarily incurred in bringing the basic raw material—limestone—to the commercially marketable product stage is includible.

The Government, by emphasizing the word "treatment" in "ordinary treatment processes," seeks to narrow the depletion base to which the percentage rate is applied. (Br. pp. 10-19, specifically pp. 11-14, 17.)

The Government's argument is strained and incorrect. First, as pointed out above, Congress was not concerned with such a technical distinction, and nothing in the legislative history indicates that "treatment" was to be given the meaning the Government urges. Rather, the record shows that *all ordinary* processes were included.

Second, the law is settled that

> ". . . in interpreting the meaning to be given words used in legislative enactments the words are to be given their known and ordinary signification. The obvious, plain and rational meaning is preferable to a narrow, strained, or hidden meaning."
>
> *Old Colony R. Co. v. Commissioner*, 284 U. S. 552, 560, 76 L. Ed. 484 (1932);
>
> *United States Gypsum Company v. United States*, 253 F. 2d 738, 744 (C. A. 7th, 1958).

Finally, the ordinary meaning of the words "treatment processes" is not as the Government alleges. Webster's New International Dictionary (2d Ed.) defines "Treatment" as: "1. Act, manner, or an instance of treating, esp. of treating a . . ., subject or a substance, as in processing; handling." "Treat" is defined as "7. To subject to some action, as of a chemical reagent; as, to *treat* a substance with sulphuric acid; often, to subject (a na-

tural or manufactured article) to some process to improve its appearance, taste, usefulness, etc.; to process; . . ."

The Government's definition of "treatment" as limited or restricted to processes "applied directly to the mineral" (Br. p. 14) is clearly not correct. "Treatment" can be and usually is, much broader in ordinary language and includes any instance where the article is subjected to processing of any kind whether something is added or not.

3. The Decision Below Is Supported by All the Decided Cases.

The Government states that the "additives" issue is "one of first appellate impression." (Br. p. 19.) The truth is, that the decided cases support taxpayer's position. It is true that in many of these cases the precise point in issue was what was the "commercially marketable product." However, implicit in these cases was the accepted premise that the addition of "additives" was an "ordinary treatment process" and that income attributable thereto was properly included in "gross income from mining." Having been soundly defeated on the "commercially marketable product" issue the Government has "doubled back," reversed its field, and has now formulated a *new* argument, contrary to its record position in other cases.

The question of "additives" was present and necessarily decided favorably to taxpayer in all the brick and tile cases,[5] where straw or other additives were added to

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[5] *United States v. Cherokee Brick & Tile Company*, 218 F. 2d 424 (C. A. 5th, 1955); *United States v. Merry Brothers Brick & Tile Company*, 242 F. 2d 708 (C. A. 5th, 1957), *cert. den.* (1957), 355 U. S. 824; *United States v. Sapulpa Brick & Tile Corp.*, 239 F. 2d 694 (C. A. 10th, 1956). See also numerous District Court decisions, *e.g.*, *Ferris Brick Co. v. United States*, 56-1 U. S. T. C. Para. 9355 (N. D. Texas, 1956).

the raw mix to obtain the commercially marketable product. The Government conceded the propriety of including additives in such cases, whether expressly or impliedly is immaterial.

The question was also present and necessarily decided favorably to taxpayer in numerous other cases. (*E.g., Northwest Magnesite Co. v. United States,* 58-1 U. S. T. C., Par. 9394 (E. D. Wash., 1958). The fact that the Government sought no allocation or exclusion of "additives" in such cases does not obscure the fact that "additives" were present, were found to be "ordinary treatment processes" and were included in "gross income from mining."

The question was expressly discussed in the opinion in *Sparta Ceramic Co. v. United States* (N. D. Ohio), decided Nov. 12, 1958 (58-2 U. S. T. C. Par. 9965) appeal pending (C. A. 6th). The Government's citation of and reliance on *Sparta* (Br. p. 18) is unfortunate, since the court there expressly rejected the Government's present argument as follows:

> "The use of additives would appear to be an ordinary process applied to obtain a commercially marketable product. Although not all of the tile produced by plaintiff contained body additives, expert testimony was given that in those instances in which it was used it was necessary to do so to avoid undesirable scumming effects resulting from certain clay mixtures, and that this was a normal practice in the industry."

The Government misleadingly goes on to quote the decision's exclusion of other additives (glazing) *after* the

commercially marketable product was obtained. The court stated:

> ". . . glazing was not necessary to obtain a commercially marketable product and, *therefore,* is not a necessary treatment process." (Italics added.)
>
> "When it has been determined, as here, that the first commercially marketable product was secured, namely unglazed tile, this ends the matter and taxpayer may not include any *unnecessary* improvement costs in computing its depletion base." (Italics added.)

Finally, the two Tenth Circuit cases relied on by Government (*United States v. Utco Products,* 257 F. 2d 65; *Commissioner v. American Gilsonite Co.,* 259 F. 2d 654) while turning on the question of "bagging,"[6] contained language *quoted by the Government* (Br. p. 12) completely supporting the taxpayer.

In *United States v. Utco,* 257 F. 2d 65, 68 (C. A. 10th, 1958) the court stated:

> "We are of the opinion that the phrase 'ordinary treatment process,' except where the statute otherwise provides, means a process of treating which separates the mineral from other minerals in which it is found or with which it is associated, *or which effects a chemical or physical change in the mineral itself* . . ." (Italics added.)

It is a fact, the record shows, and the Government stipulated that when the "additives" are blended with taxpayer's limestone, and the resultant mixture is calcined in a rotary kiln "complex chemical reactions occur, which result in entirely new compounds" which differ from the

[6]The Government admits that the Trial Court correctly excluded bagging in this case. (Note 3, Brief p. 7.)

raw mix both chemically and physically. [R. 18; Ex. 23, pp. 11, 27-28; R. 129.]

Such reactions, such physical and chemical changes, and the very production of cement itself, could not occur without the blending of "additives" with the limestone, which the Government itself admits is an "ordinary treatment process." (Br. p. 11.)

All four of the complex chemical compounds produced in taxpayer's rotary kiln [R. 18] contained calcium, which was "separated" from the limestone and chemically recombined with the silica, alumina and iron contained in both the limestone and also, as a matter of convenience, in the supplemental additives of these minerals, when subjected to heat. In fact, taxpayer could have reduced the calcium carbonates in the limestone by sorting or quarrying, but it would be more expensive than adding clays containing the silica and alumina or readily available iron cinders. Fluorspar is a chemical reagent which speeds the process, and the addition of gypsum at the finish grind creates a chemical action so as to retard the set of the cement. Such a process is clearly a "treatment" of the limestone under any definition.

The Government also misleads this Court by citing the case of *Riverton Lime & Stone Co. v. Commissioner,* 28 T. C. 446, for there, too, the first commercially marketable product was the pure hydrated lime. Naturally, the processes of adding other materials to produce additional products were not includable, since such processes were not applied to produce the commercially marketable

product. So, too, the cited decisions in *Black Mountain Corp. v. Commissioner,* 21 T. C. 746, and *Iowa Limestone Co. v. Commissioner,* 28 T. C. 881, 883 (Br. p. 19), are likewise distinguishable since they were decided on the "commercially marketable product" issue.

G. Even if Appellee's Erroneous Theory Were Adopted in Toto, There Should Be No Change in the Amount of the Trial Court's Judgment, if the Proper Method of Computation Were Employed.

Appellee, in extenuation of its strained and erroneous construction of the statute regarding additives, attempts to show that a substantial dollar difference would result were "additives" excluded. (Br. pp. 6-7.) However, the reduction in the judgment referred to by appellee (Br. pp. 6-7) is based on a computaton of depletion which ignores appellee's concession that all the processing steps are to be included in the depletion base and which is, therefore, erroneous both in theory and application. Assuming that income were to be allocated to and excluded for additives under appellee's theory (a pure fiction which the *Cherokee* decision held could be as false as often as true), there are any number of methods for computing such exclusion. Some are reasonably compatible with appellee's position. Others, including the method claimed by appellee (Br. pp. 6-7), are not.

While vigorously denying that additives are excludable, taxpayer must demonstrate the extreme error of appellee's conclusions even if appellee's theory were adopted. This necessitates a consideration of the various methods

of computing depletion. For the purposes of this case, the many methods of computing depletion can be classified into five general groups:

1. Where all additives are included;
2. Where purchased additives only are excluded by deducting the actual costs of such additives from the depletion base income and expenses;
3. Where purchased additives only are excluded by allocating some arbitrary percentage of the depletion base income and expenses to such additives;
4. Where all additives are excluded by deducting the actual costs of such additives from the depletion base income and expenses; and
5. Where all additives are excluded by allocating some arbitrary percentage of the depletion base income and expenses to such additives.

A correct application of each of the various methods making arbitrary allocations for excluded additives will result in a correct mathematical conclusion, but the conclusion will not be compatible with the theories advanced and concessions made by appellee. Such inconsistencies become apparent upon review of the figures.

1. Computation of Depletion With No Exclusion for Additives.

The first method of computing is the one originally submitted by appellee to, and adopted by, the trial court in its Findings of Fact, Conclusions of Law and Judgment [R. 66-67] and is as follows:

Sales per return			$8,702,101.20
Less: Royalties			133,340.02
			$8,568,761.18
Less: Miscellaneous sales			3,201.70
Cement sales			$8,565,559.48
Less:			
1. Trade discounts	$434,770.26		
2. Trucking—contract and own fleet costs	815,483.36		
3. Rail freight	212,558.53		
4. Warehouse and bulk storage plant costs at distribution points	49,774.95		
5. Additional charge for sales in bags	389,350.00		
Total elimination from gross sales			$1,901,937.10
Gross income from mining			$6,663,622.38
Mining expenses		$7,689,687.54	
Less:			
1. Trade discounts	$434,770.26		
2. Trucking costs—contract and own fleet	815,483.36		
3. Rail freight	212,558.53		
4. Warehouse and bulk storage plant costs at distribution points	49,774.95		
5. Costs of bags and bagging expenses	771,119.85		
Total eliminations		$2,283,706.95	
Allowable mining expense			$5,405,980.59
Net income from mining			$1,257,641.79
Depletion Allowable:			
10% of gross income		$ 666,362.24	
15% of gross income		999,543.36	
Limitation:			
50% of net income		$ 628,820.89	
Allowable depletion			$ 628,820.89

The $628,820.89 "allowable depletion deduction" is the one which results in the trial court's judgment for $264,-435.41. [R. 67, 72.]

Since none of the other exclusions made in the trial court's computation are now in issue, and in order to simplify these illustrations, the "gross income from mining" and "allowable mining expense" figures determined in this first method will be used as the starting points in the subsequent computations.

2. Computation of Depletion With Purchased Additives Excluded by Deduction of Actual Costs of Such Additives From Income and Expense.

If any exclusions are to be made for additives, then appellant contends that the only proper method for computing such exclusions is the alternative proposal of appellee that the *actual costs* of the excluded additive materials should be deducted from both gross income and from mining expenses. The costs of the excluded additive materials will then be eliminated from the depletion base and also from the costs or expenses of the "ordinary treatment processes." Under this second method, a summary computation of depletion would be as follows:

Gross income from mining, per Findings of Fact (see above)			$6,663,622.38
Less: Elimination for actual costs of purchased additives			
1. Costs of iron cinders	$ 45,539.49		
2. Costs of fluorspar	3,278.44		
Elimination for additives			48,817.93
Gross income from mining (revised)			$6,614,804.45
Allowable mining expense per Findings of Fact (see above)		$5,405,980.59	
Less: Elimination for actual costs of purchased additives			
1. Costs of iron cinders	$ 45,539.49		
2. Costs of fluorspar	3,278.44		
Elimination for additives		48,817.93	
Allowable mining expense (revised)			5,357,162.66
Net income from mining (revised)			$1,257,641.79
Depletion allowable: 10% of gross income		$ 661,480.45	
15% of gross income		992,220.67	
Limitation:			
50% of net income		$ 628,820.89	
Allowable depletion			$ 628,820.89

The above computation results in the same depletion allowance computed under the trial court's method involving no exclusion for additives. This means the judgment for $264,435.41 would remain unchanged.

The above computation (and the computation under 4 below) thus complies with the alternative position set forth by appellee. (Br. pp. 11-12.) Inserting footnote 5 (p. 12) within the last sentence beginning on page 11 (and ending on p. 12) of appellee's brief, it would read:

> "However, we strongly urge that . . ." the ". . . cost or fair market value of the raw material additives . . . should *not* be included in the depletion base."

The plain meaning of this position of appellee is that the actual costs (or fair market values) of the excluded additive materials should be deleted from the depletion base gross income and expenses determined by the trial court.

This position corresponds with appellee's position in another appellate court case involving an exclusion from the depletion base (*United States v. Utco Products, Inc.* (C. A. 10, 1958), 257 F. 2d 65 at 68), where precisely such method was employed to exclude the bagging process applied by the taxpayer *after* the "commercially marketable product" was obtained.

3. Computation of Depletion With Purchased Additives Excluded by Deduction of an Arbitrarily Allocated Percentage of Income and Expenses.

Under this method, the exclusion of additives is computed by arbitrarily *allocating* a percentage of the income and expenses to the excluded additive materials. The percentage deducted will vary, depending upon the factors to which the computor is attempting to relate the allocation. There appear to be at least three percentage methods in this case. One is based on the percentage the costs of the excluded additive materials bear to all mining expense, which percentage is used to reduce income and expense. Another is based on the percentage the costs of the excluded additive materials bear to the costs of all raw materials, which is used to reduce income and expense. The third is based on the percentage the tons of the excluded additive materials bear to the total tons of all raw materials, which is used to reduce income and expense. Appellant will consider all three.

a. *Allocation of Income on Basis of Percentage Actual Costs of Excluded Purchased Additive Materials Bear to All Mining Expenses.*

If any arbitrary percentage method of allocating income to excluded additives and computing depletion is at all reasonably compatible with appellee's position and concessions, it is this method where the deduction from expenses is on the basis of actual costs of the excluded materials and the allocation of income is based on the percentage those actual costs bear to all mining expenses.

Under this percentage method, a summary computation of depletion would be as follows:

Gross income from mining, per Findings of Fact (see above)			$6,663,622.38
Less: Elimination for allocation to purchased additives (percentage actual costs of purchased additives bear to mining expense)			
1. Allocated to iron cinders	$ 55,974.43[7]		
2. Allocated to fluorspar	4,064.81[8]		
Elimination for additives			60,039.24
Gross income from mining (revised)			$6,603,583.14
Allowable mining expense per Findings of Fact (see above)		$5,405,980.59	
Less: Elimination for actual costs of purchased additives			
1. Costs of iron cinders	$ 45,539.49		
2. Costs of fluorspar	3,278.44		
Elimination for additives		$ 48,817.93	
Allowable mining expense (revised)			$5,357,162.66
Net income from mining (revised)			$1,246,420.48
Depletion allowable:			
10% of gross income		$ 660,358.31	
15% of gross income		990,547.47	
Limitation:			
50% of net income		623,210.24	
Allowable depletion			$ 623,210.24

[7] 45,539.49 ÷ 5,405,980.59 × 6,663,622.38 = 55,974.43

[8] 3,278.44 ÷ 5,405,980.59 × 6,663,622.38 = 4,064.81

The above computation results in a depletion allowance of $623,210.24 as compared with the allowance of $628,-820.89 determined by the trial court. This means the judgment for $264,435.41 would be reduced to $261,-588.00, a difference of $2,847.41.

The reasons for the assertion above that this method of computation is reasonably compatible with appellee's position and concessions are as follows:

Appellee admits the processing steps or acts applied in blending the raw materials, etc., are ordinary treatment processes, and takes the position that only the income attributable to the additive materials themselves, not the income attributable to the processing steps, should be eliminated. (Br. pp. 11-12.) The computation referred to by appellee (Br. pp. 6-7, 11) assumes no proof of the actual costs or fair market values of the additives exists and then allocates a percentage of both income and expenses to the excluded materials. However, it is unnecessary to make an allocation for expenses, or determine fictional expenses. The actual costs of the additive materials delivered at appellant's cement plant have been ascertained and are available.

With respect to income, the amount deducted for, or allocated to, the excluded additives should properly relate to only the materials themselves, and not the many processes that are applied in appellant's operation. Such an allocation can most accurately be done by deducting the costs or fair market values of the materials themselves, or, if any arbitrary percentage method is to be applied, then by ascertaining the relationship of those costs with the total expenses incurred in the whole operation, as in the last computation. To allocate any greater portion to income would constitute the allocation and exclusion of income attributable to the processing steps, which appellee admits are includable in the depletion base. (Br. p. 11.)

b. *Allocation of Income and Expenses on Basis of the Percentage the Actual Costs of the Excluded Purchased Additive Materials Bear to the Actual Costs of All Raw Materials.*

This method allocates income and expenses to the various materials in the same proportion as the costs of the materials bear to each other. A summary computation of depletion under this method follows:

Gross income from mining, per Findings of Fact (see above)			$6,663,622.38
Less: Elimination for allocation to purchased additives (percentage actual costs of purchased additives bear to actual costs of all materials used)			
1. Allocated to iron cinders	$218,566.81[9]		
2. Allocated to fluorspar	15,992.69[10]		
Elimination for additives			234,559.50
Gross income from mining (revised)			$6,429,062.88
Allowable mining expense, per Findings of Fact (see above)		$5,405,980.59	
Less: Elimination for allocation to purchased additives (percentage actual costs of purchased additives bear to actual costs of all materials used)			
1. Allocated to iron cinders	$177,316.16[11]		
2. Allocated to fluorspar	12,974.35[12]		
Elimination for additives		190,290.51	
Allowable mining expense (revised)			5,215,690.08
Net income from mining (revised)			$1,213,372.80
Depletion allowable:			
10% of gross income		642,906.29	
15% of gross income		964,359.43	
Limitation:			
50% of net income		606,686.40	
Allowable depletion			$ 606,686.40

[9] 45,539.49 ÷ 1,391,412.37 × 6,663,622.38 = 218,566.81
[10] 3,278.44 ÷ 1,391,412.37 × 6,663,622.38 = 15,992.69
[11] 45,539.49 ÷ 1,391,412.37 × 5,405,980.59 = 177,316.16
[12] 3,278.44 ÷ 1,391,412.37 × 5,405,980.59 = 12,974.35

The above computation results in a depletion allowance of $606,686.40 as compared with the allowance of $628,-820.89 determined by the trial court. This means the judgment for $264,435.41 would be reduced to $253,-202.16, a difference of $11,233.25.

The fiction involved in any of these methods arbitrarily allocating income or expense can be illustrated in the last computation. Since the allocation is based on the proportionate costs of the various raw materials, the high unit cost materials will be allocated a greater relative share of income and expenses. For example, fluorspar is a very high unit cost material. The amount of expenses allocated to it in the above computation is $12,-974.35, *four times its actual cost* shown in method 2 above.

The major defect in this method is that it is obviously allocating and excluding income and expenses which are attributable to the admittedly includable processing steps.

c. *Allocation of Income and Expenses on Basis of the Percentage the Tons of Excluded Purchased Additive Materials Bear to the Tons of All Raw Materials Used.*

Here, income and expenses are allocated to the various materials in the same proportion as the tonnages used of the materials bear to each other. A summary computation of depletion under this method follows:

Gross income from mining, per Findings of Fact (see above)			$6,663,622.38
Less: Elimination for allocation to purchased additives (percentage tons purchased additives bear to all materials used)			
1. Allocated to iron cinders	$ 54,308.52[13]		
2. Allocated to fluorspar	733.00[14]		
Elimination for additives			$ 55,041.52
Gross income from mining (revised)			$6,608,580.86
Allowable mining expense, per Findings of Fact (see above)		$5,405,980.59	
Less: Elimination for allocation to purchased additives (percentage tons purchased additives bear to all materials used)			
1. Allocated to iron cinders	$ 44,058.74[15]		
2. Allocated to fluorspar	594.66[16]		
Elimination for additives		$ 44,653.40	
Allowable mining expense (revised)			$5,361,327.19
Net income from mining (revised)			$1,247,253.67
Depletion allowable:			
10% of gross income		$ 660,858.09	
15% of gross income		991,287.13	
Limitation: 50% of net income		$ 623,626.83	
Allowable depletion			$ 623,626.83

[13] 7,563 ÷ 928,292 × 6,663,622.38 = 54,308.52
[14] 98 ÷ 928,292 × 6,663,622.38 = 733.00
[15] 7,563 ÷ 928,292 × 5,405,980.59 = 44,058.74
[16] 98 ÷ 928,292 × 5,405,980.59 = 594.66

The above computation results in a depletion allowance of $623,626.83 as compared to the allowance of $628,-820.89 determined by the trial court. This means the judgment of $264,435.41 would be reduced to $261,-799.42, a difference of $2,635.99.

Again, the fiction involved in arbitrarily allocating income and expense is illustrated. The expenses allocated to iron cinders and fluorspar in the above computation are less than the actual costs of those two materials (shown in method 2 above). This is especially true in the case of fluorspar. The reason for this difference is that fluorspar has a high unit cost.

The method last computed is, in principle, the same method used in Exhibit 29 of the record. The difference between the results of $261,799.42 (computed above) and $261,523.48 [Ex. 29, showing a refund of $260,773.20, plus assessed interest of $750.28] is due, basically, to the fact that in Exhibit 29, no allowance is made for the other exclusions determined by the trial court. It should be noted that Exhibit 29 was not prepared because appellant considered it the correct method of computing allowable depletion, *e.g.,* the exclusion of purchased additives. It was prepared in connection with settlement arrangements appellant thought it had concluded with appellee, and represented a compromise to effect speedy settlement (which never materialized).

To this point, appellant has submitted the calculations that are material to appellee's claim of possible double depletion, and the greatest possible reduction (under even most unreasonable methods) is $11,233.25. All other additives were mined by appellant, concededly, as part of the ordinary treatment processes applied by appellant in producing the "commercially marketable product."

4. **Computation of Depletion With All Additives Excluded by Deduction of Actual Costs of All Additives From Income and Expense.**

This method is the same as method 2 above except that here all the additives are excluded. A summary computation of depletion under this method follows:

Gross income from mining, per Findings of Fact (see above)			$6,663,622.38
Less: Elimination for actual costs of all additives			
1. Costs of iron cinders	$ 45,539.49		
2. Costs of fluorspar	3,278.44		
3. Costs of clay #1	13,067.08		
4. Costs of clay #2	5,635.20		
5. Costs of tufa	30,232.21		
6. Costs of gypsum	152,489.72		
Elimination for additives			$ 250,242.14
Gross income from mining (revised)			$6,413,380.24
Allowable mining expense, per Findings of Fact (see above)		$5,405,980.59	
Less: Elimination for actual costs of all additives			
1. Costs of iron cinders	$ 45,539.49		
2. Costs of fluorspar	3,278.44		
3. Costs of clay #1	13,067.08		
4. Costs of clay #2	5,635.20		
5. Costs of tufa	30,232.21		
6. Costs of gypsum	152,489.72		
Elimination for additives		$ 250,242.14	
Allowable mining expense (revised)			$5,155,738.45
Net income from mining (revised)			$1,257,641.79
Depletion allowable:			
10% of gross income		$ 641,338.02	
15% of gross income		$ 962,007.04	
Limitation:			
50% of net income		$ 628,820.89	
Allowable depletion			$ 628,820.89

As in the computations under methods 1 and 2 above, the resulting depletion allowance is $628,820.89. This means the judgment for $264,435.41 would remain unchanged.

And, as stated under 2 above, the above computation complies with appellee's alternative position (Br. pp. 11-12), and corresponds with appellee's position in the Tenth Court of Appeals' case of *United States v. Utco Products, Inc.*

It is appellant's contention that if appellee's theory is adopted *in toto,* then the allowable depletion deduction should be determined in accordance with the last above computation.

5. Computation of Depletion With All Additives Excluded by the Deduction of an Arbitrarily Allocated Percentage of Income and Expenses.

As in 3 above, there are three methods of allocating income and expenses on a percentage method. The three variations will be considered separately as to their application to the exclusion of all additives.

a. *Allocation of Income on Basis of Percentage the Actual Costs of Excluded Additive Materials Bear to All Mining Expenses.*

It is this method (comparable to 3a) of arbitrarily allocating fictional income which appellant contends is most compatible with the position and concessions of appellee.

A summary computation of depletion under this method follows:

Gross income from mining, per Findings of Fact (see above)			$6,663,622.38
Less: Elimination for allocation to additives (percentage actual costs bear to mining expense)			
1. Allocated to iron cinders	$ 55,974.43[17]		
2. Allocated to fluorspar	4,064.81[18]		
3. Allocated to clay #1	15,992.69[19]		
4. Allocated to clay #2	6,930.17[20]		
5. Allocated to tufa	37,316.29[21]		
6. Allocated to gypsum	187,914.15[22]		
Elimination for additives			$ 308,192.54
Gross income from mining (revised)			$6,355,429.84
Allowable mining expense, per Findings of Fact (see above)		$5,405,980.59	
Less: Elimination for actual costs of additives			
1. Costs of iron cinders	$ 45,539.49		
2. Costs of fluorspar	3,278.44		
3. Costs of clay #1	13,067.08		
4. Costs of clay #2	5,635.20		
5. Costs of tufa	30,232.21		
6. Costs of gypsum	152,489.72		
Elimination for additives		$ 250,242.14	
Allowable mining expense (revised)			$5,155,738.45
Net income from mining (revised)			$1,199,691.38
Depletion allowable:			
10% of gross income		$ 635,542.98	
15% of gross income		$ 953,313.48	
Limitation:			
50% of net income		$ 599,845.69	
Allowable depletion			$ 599,845.69

[17] 45,539.49 ÷ 5,405,980.59 × 6,663,622.38 = 55,974.43

[18] 3,278.44 ÷ 5,405,980.59 × 6,663,622.38 = 4,064.81

[19] 13,067.08 ÷ 5,405,980.59 × 6,663,622.38 = 15,992.69

[20] 5,635.20 ÷ 5,405,980.59 × 6,663,622.38 = 6,930.17

[21] 30,232.21 ÷ 5,405,980.59 × 6,663,622.38 = 37,316.29

[22] 152,489.72 ÷ 5,405,980.59 × 6,663,622.38 = 187,914.15

The above computation results in a depletion allowance of $599,845.69 as compared with the allowance of $628,-820.89 determined by the trial court. The judgment would be reduced from $264,435.41 to $249,730.50, or a difference of $14,704.91.

The justification for this method is discussed in 2 above. Primarily, it is (1) that the deduction from expenses is for the *actual costs* only, and (2) the allocation of income, being in the same proportion as the deducted actual additive costs bear to total mining expenses, is more likely to relate to only the additive materials themselves, rather than the many processing steps which are not to be excluded (Br. p. 11).

b. *Allocation of Income and Expenses on the Basis of the Percentage the Actual Costs of the Excluded Additive Materials Bear to the Actual Costs of All Raw Materials.*

This method is similar to method 3b. above except that it is applied to the exclusion of all additives. It involves the allocation of fictional income and expenses in the proportion the actual costs of the additive materials bear to the actual costs of all materials. The computation of depletion thereunder is as follows:

Gross income from mining, per Findings of Fact (see above)			$6,663,622.38
Less: Elimination for allocation to additives (percentage actual costs of additives bear to actual costs of all materials used)			
1. Allocated to iron cinders	$218,566.81[23]		
2. Allocated to fluorspar	15,992.69[24]		
3. Allocated to clay #1	62,638.05[25]		
4. Alocated to clay #2	26,987.67[26]		
5. Allocated to tufa	144,600.61[27]		
6. Allocated to gypsum	730,333.01[28]		
Elimination for additives			$1,199,118.84
Gross income from mining (revised)			$5,464,503.54
Allowable mining expense, per Findings of Fact (see above)		$5,405,980.59	
Less: Elimination for allocation to additives (percentage actual costs of additives bear to actual costs of all materials used)			
1. Allocated to iron cinders	$177,316.16[29]		
2. Allocated to fluorspar	12,974.35[30]		
3. Allocated to clay #1	50,816.22[31]		
4. Allocated to clay #2	21,894.22[32]		
5. Allocated to tufa	117,309.78[33]		
6. Allocated to gypsum	592,495.47[34]		
Elimination for additives		$ 972,806.20	
Allowable mining expense (revised)			$4,433,174.39
Net income from mining (revised)			$1,031,329.15
Depletion allowable:			
10% of gross income		$ 546,450.35	
15% of gross income		$ 819,675.53	
Limitation:			
50% of net income		$ 515,664.57	
Allowable depletion			$ 515,664.57

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[23] 45,539.49 ÷ 1,391,412.37 × 6,663,622.38 = 218,566.81
[24] 3,278.44 ÷ 1,391,412.37 × 6,663,622.38 = 15,992.69
[25] 13,067.08 ÷ 1,391,412.37 × 6,663.622.38 = 62,638.05
[26] 5,635.20 ÷ 1,391,412.37 × 6,663,622.38 = 26,987.67
[27] 30,232.21 ÷ 1,391,412.37 × 6,663,622.38 = 144,600.61
[28] 152,489.72 ÷ 1,391,412.37 × 6,663,622.38 = 730,333.01
[29] 45,539.49 ÷ 1,391,412.37 × 5,405,980.59 = 177,316.16
[30] 3,278.49 ÷ 1,391,412.37 × 5,405,980.59 = 12,974.35
[31] 13,067.08 ÷ 1,391,412.37 × 5,405,980.59 = 50,816.22
[32] 5,635.20 ÷ 1,391,412.37 × 5,405,980.59 = 21,894.22
[33] 30,232.21 ÷ 1,391,412.37 × 5,405,980.59 = 117,309.78
[34] 152,489.22 ÷ 1,391,412.37 × 5,405,980.59 = 592,495.47

The computation results in a depletion allowance of $515,664.57 as compared to the depletion allowance of $628,820.89 determined by the trial court. The judgment would then be reduced from $264,435.41 to $207,008.58, or a difference of $57,426.83.

As discussed under 3b. above, the fictional character of the allocations made under this method are quite apparent. The allocation relates to the cost or value of the material involved and, of necessity, involves the allocation of income and expenses attributable to all the many processing operations. Gypsum, although used in quantities less than the clays, is allocated much greater shares of the allocated income and expense under this method because of its high unit cost. Actually, it would appear that proportionately less income and/or expense should be allocated to gypsum because gypsum is introduced at the very end of the processing operations, after the blending, grinding and burning of the other materials [R. 24].

c. *Allocation of Income and Expenses on Basis of the Percentage the Tons of Additive Materials Used Bear to the Total Tons of All Raw Materials Used.*

Here, we have the method set forth in 3c. above applied to the exclusion of all additives. The allocation of income and expenses is proportionate to the tons of the materials used. A summary computation thereunder follows:

Gross income from mining, per Findings of Fact (see above)			$6,663,622.38
Less: Elimination for allocation to additives (percentage tons additives bear to tons all materials used)			
1. Allocated to iron cinders	$ 54,308.52[35]		
2. Allocated to fluorspar	733.00[36]		
3. Allocated to clay #1	682,354.93[37]		
4. Allocated to clay #2	155,262.40[38]		
5. Allocated to tufa	65,969.86[39]		
6. Allocated to gypsum	167,923.28[40]		
Elimination for additives			1,126,551.99
Gross income from mining (revised)			$5,537,070.39
Allowable mining expenses, per Findings of Fact (see above)		$5,405,980.59	
Less: Elimination for allocation to additives (percentage tons additives bear to tons all materials used)			
1. Allocated to iron cinders	$ 44,058.74[41]		
2. Alocated to fluorspar	594.66[42]		
3. Allocated to clay #1	553,572.41[43]		
4. Allocated to clay #2	125,959.35[44]		
5. Allocated to tufa	53,519.21[45]		
6. Allocated to gypsum	136,230.71[46]		
Elimination for additives		913,935.08	
Allowable mining expense (revised)			$4,492,045.51
Net income from mining (revised)			$1,045,024.88
Depletion allowable:			
10% of gross income		$ 553,707.04	
15% of gross income		830,560.56	
Limitation:			
50% of net income		522,512.44	
Allowable depletion			$ 522,512.44

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[35] 7,563 ÷ 928,292 × 6,663,622.38 = 54,308.52
[36] 98 ÷ 928,292 × 6,663,622.38 = 733.00
[37] 95,102 ÷ 928,292 × 6,663,622.38 = 682,354.93
[38] 21,659 ÷ 928,292 × 6,663,622.38 = 155,262.40
[39] 9,223 ÷ 928,292 × 6,663,622.38 = 65,969.86
[40] 23,393 ÷ 928,292 × 6,663,622.38 = 167,923.28
[41] 7,563 ÷ 928,292 × 5,405,980.59 = 44,058.74
[42] 98 ÷ 928,292 × 5,405,980.59 = 594.66
[43] 95,102 ÷ 928,292 × 5,405,980.59 = 553,572.41
[44] 21,659 ÷ 928,292 × 5,405,980.59 = 125,959.35
[45] 9,223 ÷ 928,292 × 5,405,980.59 = 53,519.21
[46] 23,393 ÷ 928,292 × 5,405,980.59 = 136,230.71

The above method results in a depletion allowance of $522,512.44 as compared to the allowance of $628,820.89 determined by the trial court. This would mean a reduction in the judgment from $264,435.41 to $210,483.87, or a difference of $53,951.54.

This computation is, in principle, the same as the computation referred to by appellee (Br. pp. 6-7, 11). The difference between the $210,483.87 and the $209,950.86 referred to by appellee arises out of appellee's failure to make allowances for the other exclusions determined by the trial court. In effect, appellee's computation allocates some income and expenses twice.

Regardless of how appellee actually computed its allocations, appellant contends that any method of computation which *arbitrarily allocates* a certain percentage of income and expense as being attributable (a mere fiction) to additives is fallacious, unfair, and contrary to the clear and simple method of computing mineral depletion established by Congress.

It should be noted that in none of these computations is a depletion allowance made for taxpayer's *mined* additives, which appellee concedes are entitled to separate appropriate depletion allowances (Br. p. 16) if appellee's theory of excluding additives is adopted.

Finally, appellant reiterates that under the clear Congressional mandate, *all* additives are includable. The foregoing computations are presented merely to demonstrate the error of appellee's assertions as to the amount involved if additives are excluded, and incidentally, to highlight the controversies over the proper method of computation which Congress avoided by adopting the simple "commercially marketable product" rule.

III.

APPELLEE HAS BEEN GUILTY OF BAD FAITH THROUGHOUT THIS CASE.

It is difficult to conceive what makes the attorneys representing the Internal Revenue Service deviate from the code of ethics usually followed and respected in connection with judicial proceedings.

The only logical explanation seems to be that the Internal Revenue Service has decided that it is to its interest to ride roughshod over the courts, counsel and parties under the cloak of its believed sovereign rights. The income tax is the greatest single cost item of all business including manufacturing. The Internal Revenue Service is also the most onerous creditor with its ability to arbitrarily levy upon private property. In this context, Revenue's refusal to meet minimum standards of accepted conduct in judicial proceedings is most alarming.

Appellant believes that the Internal Revenue Service would benefit by being compelled to recognize the existing law applicable to actions by or against the Government, which is that the Commissioner is bound by the conduct, concessions and admissions of his counsel, just as counsel for any other litigant.

As stated by the court in *Lenox Clothes Shops v. Commissioner,* 139 F. 2d 56, 59 (C. C. A. 6th, 1943):

> "We gather from the record that respondent (Commissioner) was represented by able counsel and under such circumstances respondent (Commissioner) is required to observe the admissions and stipulations of counsel of record during the trial of a case, just as counsel for any other litigant."

See also:

United States v. Stinson, 197 U. S. 200, 205, 49 L. Ed. 724 (1905);

Commissioner v. Erie Forge Co., 167 F. 2d 71, 75 (C. C. A. 3d, 1948).

Believing that justice and the expeditious administration of the tax laws will be served thereby, appellant makes bold to delineate the many proofs of this sort of conduct in this case by many counsel.

Although a certain amount of misunderstanding is bound to occur in every case, and although in their role as advocates counsel may well reach for extreme positions, taxpayer believes that the present record conclusively demonstrates the bad faith of appellee. Since continuing litigation appears to be the only way taxpayer can obtain its legal rights at a substantial cost in time and money, taxpayer feels obligated to collate the cumulative evidence of such bad faith at this time. Possibly this record may obviate such flagrant double-dealing in the future, if responsible persons are advised of the character and extent of the conduct complained of.

A. The Negotiated Settlement Below Which Appellee Dishonored.

On December 20, 1957, Monolith offered to settle on the basis that the costs "attributable to iron cinders, fluorspar and bags and bagging be excluded." [R. 44.]

On January 2, 1958, as an inducement to Monolith's agreeing to a further continuance, the Government, by Charles K. Rice (Assistant Attorney General, Tax Division), accepted Monolith's offer, advising that the District Director had been directed to recompute the tax on the proposed basis. [R. 44.]

On January 9, 1958, Monolith replied:

> ". . . This basis is satisfactory to Monolith. In addition we will continue our joint effort to conclude both the Monolith and Monolith Portland Midwest Company tax refund matters for the years 1951 to and including 1954. . . ." [R. 44-45.]

Thereafter, appellee refused to honor this settlement.

B. Having Stipulated to Well Established Facts as to Taxpayer's Operation and Industry Practices, When Faced With Requests for Admissions and Discovery, Appellee Now Seeks to Repudiate Such Stipulation.

When the case was first filed, many complex, involved facts necessary to taxpayer's proof of its operation and industry practices were well-known to appellee by reason of its audits, field inspections of taxpayer's quarry and plant, etc. Taxpayer served Requests for Admissions and Interrogatories. [Clk. Tr. pp. 89, 336, 373.] Faced with the penalty provisions of the Federal Rules for refusing discovery in bad faith, appellee finally agreed to stipulate to the basic facts.

The appellee stipulated that those steps or processes applied by appellant where the other materials are blended with limestone are includible in determining gross income from mining as follows [Stip. of Facts No. 1, par. VIII, H; R. 21, 22].

> "The parties to this action agree that the extraction and processing operations set forth below for the mining of the calcium carbonate rock generally known as 'limestone' are includable in determining gross income from mining under section 114(b) of the Internal Revenue Code of 1939, as amended, and were employed by plaintiff at its quarry and cement

plant at Monolith, California, during the year 1951 in order to obtain various types of Portland cement.

*   *   *   *   *   *   *   *

"H. The limestone from its hopper is then blended with clay #1 from another hopper, with clay #2 from another hopper and with iron cinders from another hopper by measuring and conveying equipment."

The Government also stipulated that the addition of gypsum at the finish grind stage was included in the ordinary treatment processes normally applied in the cement industry. [Stip. of Facts No. 1, pars. IX, B and X; R. 23, 24.]

In addition, the parties to this action stipulated to the minute physical and chemical details concerning the additive materials [Stip. of Facts No. 1, pars. V-VII; R. 18-21]; and that all steps or processes applied by appellant in order to obtain finished cement are the usual and customary process steps applied in the cement industry to obtain finished cement. [Stip. of Facts No. 1, par. X; R. 24.]

As shown by its Brief (pp. 10-19, specifically p. 17), appellee now seeks to "wiggle out" of its stipulation deliberately made below by experienced tax counsel. In fact appellee brazenly contends that "There is no provision in the stipulation that the cost of additional materials or the income attributable to them should be included in the computation." On this record, such contention is absolutely without foundation. The language used is accurate and precise.

C. The Appellee's Conduct During Trial When Presenting Findings of Fact.

At the close of testimony on March 21, 1958, Judge Mathes ruled that all additives were includable as a part of gross income from mining, and directed further argument on the "chemical grade limestone" issue only.

Thereafter, on March 24, 1958, following argument solely directed to the "chemical grade limestone" issue, previously characterized by the Court as the only remaining issue in the case, the Court announced its decision as follows [March 24, 1958, Rep. Tr. p. 180]:

> "The Court: This isn't an easy question for me, but I shall rule that it's 10 per cent.
>
> And there is nothing further to rule on, is there, in this case? Haven't I ruled on everything else?
>
> Mr. Enright: I believe so.
>
> The Court: Can't you prepare findings of fact, conclusions of law and judgment based on the rulings that have been made?
>
> Mr. Enright: Yes, your Honor.
>
> The Court: Very well. I will ask you to do so and settle them under Local Rule 7."

Pursuant to the Court's direction, appellant lodged with the Court and furnished to appellee complete Findings of Fact, Conclusions of Law and Judgment on March 25, 1958. There was no exclusion for additives in appellant's Findings of Fact and Conclusions of Law. Thereafter, on March 27, 1958, the appellee appeared and asked for more time to consider objections to appellant's Findings of Fact and Conclusions of Law and to prepare its own Proposed Findings of Fact and Conclusions of Law, but did not ask

for the exclusion of any additives at that time. On April 4, 1958, appellee lodged with the Court and furnished to appellant its Proposed Findings of Fact, Conclusions of Law and Judgment which did not exclude any additives. Thereafter, on April 9, 1958, the appellee filed its Proposed Amendments to Proposed Findings of Fact and Conclusions of Law. Such amendment *for the first time* proposed that additives should be excluded from gross income and expense, presumably on the appellee's theory presented in its brief.

In view of the 18 months of proceedings during which appellee's counsel made numerous stipulations and statements defining the issues, Judge Mathes took a very dim view of the timeliness and merit of the proposed amendment. [Rep. Tr. of April 14, 1958, p. 3, line 6.]

> "The Court: You received some additional instructions from Washington, I take it, Mr. Messer?
>
> Mr. Messer: Yes, your Honor.
>
> The Court: Well, they are a little late and they're a little unmeritorious, shall I say."

Judge Mathes, of course, was familiar with the stipulation of facts, having based his decision in part thereon.

Thereafter, the following colloquy occurred [Rep. Tr. pp. 5, 6]:

> "The Court: Mr. Messer, have you read what the plaintiff filed this morning?
>
> Mr. Messer: I just received it as I walked into the court room.
>
> The Court: You will blush when you read it, because it certainly does put the government in a very undignified light in this case. I have taken it good-humoredly up to now, but we have reached the limit.

Mr. Messer: Well, your Honor, from the transcript—

The Court: You have heard the phrase 'trifling with the court,' haven't you?

The Government's conduct in this case borders very much on 'trifling with the court.'

Mr. Messer: Now, your Honor, I don't want to be accused of trifling with the court—

The Court: I am not accusing you, because I don't think you have anything to do with it."

The Court denied appellee's motion to amend [R. 61], and, after certain changes by interlineation, concerning what is chemical grade limestone, announced that it would approve the Findings of Fact and Conclusions of Law furnished by the appellee on April 4, 1958.

D. Appellee, Having Stipulated to Exclude Bags and Bagging Below, Designated the Court's Decision in Accordance Therewith as Error.

Appellee agreed below that bags and bagging should be excluded in this case. [R. 99-100, 113.]

On its cross-appeal, appellee designated the court's decision in excluding bags as error. [R. 148-149, incorporating designation filed in District Court.]

Despite the fact that the point was clearly without merit and a reversal of trial court agreed procedure, taxpayer was required to, and did expend substantal time and effort in preparing the bagging issue on this appeal.

In its Brief, appellee abandons the bagging issue (p. 7) stating that it was "designated as error for protective purposes only."

E. Appellee's Conduct Before This Court Is Subject to Censure.

Passing the many instances of appellee's misleading and inaccurate "short-quotes" and similar borderline conduct, taxpayer refers the court to page 17 of appellee's Brief.

Appellee states:

> "Indeed, . . . At one point taxpayer expressed a willingness to concede the issue as to the purchase(d) additives [R. 111] . . ."

When the cited record is read, the truth appears. Taxpayer then *offered to compromise* the additives issue to settle the *whole* case. [R. 111.] The method of computation *included* the mined additives and *excluded* the purchased additives. Such offer was made in the belief that the basic agreement for settlement discussed in "A" above had been reached. Appellee now implies that such "willingness" represented a vacillation in theory by taxpayer. Again the record is twisted, and appellee seeks to use an offer of compromise as *evidence* of a fact—a careless disregard of elementary principles of evidence as well as ethics.

IV.

TAXPAYER HAS ESTABLISHED THAT THE ONLY REASONABLE INTERPRETATION OF "CHEMICAL GRADE LIMESTONE" IS LIMESTONE SUITABLE FOR USE IN AN INDUSTRIAL CHEMICAL PROCESS SUCH AS CEMENT, AND THAT ITS LIMESTONE IS SUBJECT TO THE 15% RATE OF DEPLETION.

As fully discussed in its opening brief, taxpayer established the following decisive undisputed facts:

1. Congress directed that "chemical grade limestone" be given its commonly understood commercial meaning (Op. Br. p. 19);
2. "Chemical grade limestone" had no commonly understood commercial meaning (Op. Br. pp. 20-21);
3. The cement industry was a chemical process industry (Op. Br. pp. 17-18);
4. The only reasonable interpretation of the Congressionally coined phrase was any limestone suitable for an industrial chemical use (Op. Br. pp. 20-26);
5. Taxpayer's limestone in question was suitable for and used in an industrial chemical process. [R. 18.]

On this clear record, taxpayer's limestone is entitled to depletion at the rate of 15% as provided in Section 114 (b)(4)(A)(iii) of the Internal Revenue Code of 1939, and the Court erred in holding the contrary.

A. Appellee Does Not Challenge Taxpayer's Documented Proof That the Cement Industry Is a "Chemical Industry."

In its opening brief, taxpayer established that the cement industry is a chemical process industry, as are the glass, alkali, lime, paper, etc. industries, as to which appellee has

allowed a 15% rate under Section 114(b)(4)(A)(iii) for the limestone used therein. (Br. pp. 12, 17-19, 28-29.)

Appellee does not contend otherwise in its brief, and it is therefore undisputed.

B. The Appellee's Own "Expert" Witness Admitted That the Suitability of Particular Limestone for a "Chemical Industry" Use Was the Proper Test for Determining That Such Limestone Was of Chemical Grade.

As discussed more fully hereafter, Dr. Bowles, appellee's "expert" witness from the Bureau of Mines admitted that the suitability of a limestone for use in a "chemical industry" was the proper test to determine whether a particular limestone is "chemical grade." [Ex. 23, p. 89.]

This important admission establishes that taxpayer's limestone used in producing cement (an admittedly chemical industry) is "chemical grade limestone."

C. Appellee's Argument on "Chemical Grade Limestone" Is Based on Its Assertion That Such Phrase Has an "Accepted" Meaning. This Assertion and Such Argument Are Contrary to the Record Facts.

1. Introduction.

As pointed out in taxpayer's opening brief (pp. 8-11) and as admitted by appellee (Br. p. 20), taxpayer is aggrieved by the trial court's decision that its limestone is not "chemical grade" under Section 114(b)(4)(A).

The appellee has failed to answer taxpayer's showing (Op. Br. pp. 16-17) that the issue of whether taxpayer's limestone is or is not "chemical grade limestone" is a mixed question of law and fact, and that this Court is

not bound by the trial court's finding under Rule 52, F. R. C. P.

Simply stated, the issue is whether taxpayer's limestone[47] is "chemical grade limestone" and thus subject to the 15% rate of depletion provided in Section 114(b)(4)(A).

2. There Is No "Accepted" Meaning of the Phrase "Chemical Grade Limestone."

Basically, appellee argues that there *is* an "accepted" meaning of the term "chemical grade limestone." (Br. p. 23.) Such assertion finds no support in this record.

(a) *The Testimony of Dr. Bowles Was That the Term "Chemical Grade Limestone" Was Not Used in Industry or Commerce.*

As pointed out in taxpayer's opening brief (pp. 14-15) Dr. Bowles admitted that he had no knowledge of the use of the phrase "chemical grade limestone" in the lime industry, the glass industry, the alkali industry, or any other industry he classified as "chemical." [R. 122-123.] He also testified that he had never used the term "chemical grade limestone" in his 35 years with the Bureau of Mines, nor had he ever seen it used in official publications. [R. 123.]

Dr. Bowles also admitted that the reason he (personally) classified taxpayer's limestone as not being "chemical grade" was because he believed that the cement industry was not a chemical industry [Ex. 23, p. 89], and hence necessarily admitted that whether a particular limestone was "chemical grade" or not depended entirely on the

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[47]Although appellee admits at page 3 of its brief that taxpayer operates a "limestone quarry" and "mined limestone" it thereafter persists in referring to such "limestone" as "calcium carbonate rock."

"chemical" character of the industry and *not* any arbitrary chemical analysis test.

Appellee attempts to support its contention that the term "chemical grade limestone" has an "accepted" meaning by referring to one isolated spot in Dr. Bowles' deposition. [R. 124-126.] At this place (Dr. Bowles having previously admitted that he had no "knowledge" of the use of the term in industry or commerce), artfully led by counsel, over objection, the following testimony occurred [R. 124]:

> "Q. Have you ever heard the term, Chemical Grade Limestone, used in the limestone industry? A. Do you mean by the producers themselves?
>
> Q. Yes. A. I cannot recollect at this time, no."

Taxpayer submits that it is thus undisputed that there is no "accepted" meaning for "chemical grade limestone." Dr. Bowles' *conclusions* are (1) not facts; and, (2) no stronger than the facts he relies upon to make his conclusions—*i.e.,* merely that certain industries buy limestone containing more calcium than do other industries. This falls far short of the "accepted" or "ordinary" meaning intended by Congress.

(b) *Appellee Argues That Chemical Grade Limestone Is Limestone of a Relatively High Calcium Carbonate content, but Offered no Serious Rebuttal to Taxpayer's Showing That Such Meaning Was Not Known to Industry.*

Taxpayer's proof established that there was no "accepted" or "ordinary" meaning for "chemical grade limestone" in commerce or industry. [Ex. 23, R. 122.]

Appellee, when asserting there is an "accepted" meaning of chemical grade limestone neglects to advise the court

that in other reported cases (*e.g., Wagner Quarries Co. v. United States,* 154 Fed. Supp. 655, at 659) it agreed that there was no "commonly understood commercial meaning." Congress intended that "The names of all the various enumerated minerals are of course intended to have their commonly understood commercial meaning . . ." (Sen Finance Committee Rep. No. 781, 82nd Cong., 1st Sess.. p. 38.)

D. No Decided Case Has Held That Limestone Suitable for Use in a Chemical Industrial Application Is Not "Chemical Grade Limestone."

Appellee misleadingly seeks to create the impression that several courts have passed on the question here presented, and have decided the issue adversely to taxpayer. This is not true.

The two cases of *Riverside Cement Co. v. United States* (S. D. Calif.), decided September 30, 1958 (58-2 U. S. T. C. par. 9905), and *California Portland Cement Company v. Riddell* (S. D. Calif.), decided November 21, 1958 (59-1 U. S. T. C. par. 9156), appeal pending (C. A. 9th) cited by appellee (Br. p. 21) were both decided by Judge Mathes, who decided this case. Understandably, Judge Mathes has been consistent.

In the case of *Dragon Cement Co. v. United States,* 144 Fed. Supp. 188, 189 (D. C. Me.), reversed 244 F. 2d 513 (C. A. 1st, 1957), cert. den. (1957) 355 U. S. 833, the question of the proper *rate* of depletion was not reached by the Court of Appeals. The District Court decision is not an authority, here, or even persuasive, in view of the glaring error in statutory construction by that court which resulted in reversal on the "commercially marketable product issue," and more importantly, the tax-

payer there sought only a 10% rate on its rare friable calcium carbonate material called cement rock.

As pointed out by taxpayer (Op. Br. pp. 24-25) the *Wagner Quarries* case[48] directly supports taxpayer's contention that its limestone, suitable for an industrial chemical use, is "chemical grade limestone" and entitled to the 15% rate. Appellee's citation of *Wagner Quarries* (Br. p. 22) is typical. Appellee (as is its practice) selects an isolated statement which *appears* to support appellee's argument. However, when read in context with the facts and the rest of the opinion, the appellee's reliance on the quoted language is misplaced. As the District Court points out (and the Court of Appeals approved), "suitability" is the test—not an arbitrary chemical content test. Finally, use in a cement process was found in the *Wagner* case to be a "chemical" use.

The question here presented was not considered in the case of *Iowa Limestone Co. v. Commissioner,* 28 T. C. 881. In that case the principal issue was what was the "commercially marketable product." The second issue was whether taxpayer's limestone, which was 95% carbonates, was "chemical grade." The Court held that it was. The Court was clearly right in its decision, since such limestone was "suitable" for use in industrial chemical applications. However, since the Tax Court did not have before it a limestone averaging 85% carbonates for the year 1951 (as is taxpayer's here) any expression of contrary opinion not necessary to the decision is dicta. In

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[48]*Wagner Quarries Co. v. United States,* 154 F. Supp. 655 (D. C. N. D. Ohio, 1957); affirmed, *United States v. Wagner Quarries Co.,* 260 F. 2d 907 (C. A. 6th, Nov. 14, 1958).

addition, even the Tax Court's statement quoted by appellee (Br. p. 22) can have one of two meanings:

(1) That *any* limestone which is less than 95% carbonates is not "chemical grade"; *or, more reasonably,*

(2) Merely that *a 95%* carbonates limestone is clearly "chemical grade."

The meaning which disposes of only the issue before the Court is, we submit, the proper construction—*i.e.,* that the 95% carbonates limestone there in issue was held to be "chemical grade," and that the Court did not pass on other limestone of lesser carbonates content not before it.

To the extent that the *Iowa Limestone* case is construed otherwise, taxpayer submits it is clearly error.

Appellee cites but one other case, *Virginian Limestone Corp. v. Commissioner,* 26 T. C. 553 (Br. p. 24), which, as the appellee admits (Br. p. 22), invalidated the appellee's "end-use" regulation. (Reg. 111, Sec. 29.23(m)-5.) The *Virginian* case is not relevant to the issue here presented since neither party is here contending for an end use test, and that was the issue *Virginian* decided.

E. Appellee Cannot and Does Not Explain Why It Has Repudiated Its Express Earlier Ruling That "Calcination" Is a Chemical Process and That Limestone Suitable for Calcination Is Therefore "Chemical Grade."

As taxpayer pointed out in its opening brief (Op. Br. pp. 29-30) the crux of appellee's Revenue Ruling 56-582 (C. B. 1956-2, 981), (apart from the invalid "end-use" test), was the admission therein that *"since"* "calcination" was a "chemical process" any "calcium carbonate" used for producing lime by calcination was therefore "chemical grade limestone."

Appellee attempts to dismiss such admission in its own earlier (until judicially disapproved) regulation by stating that the end-use test is "no longer being urged." It also superfluously points out that lime is not cement. But *nowhere* does appellee attempt to rebut the scientific fact and cold logic that since calcination *is* a chemical process, a limestone suitable for "calcination" is by definition, "chemical grade limestone."

Parenthetically, it should be noted that, again, appellee overstates its case. Although appellee asserts that: "the record here is clear that the taxpayer's deposit could not be used in the production of lime [Ex. 23, R. 127]," the quoted reference does not support it. Dr. Bowles, the "insulated" expert witness who had no "knowledge" of industry use of the phrase "chemical grade limestone" there asserted that: *"A large part* of the lime manufactured in the United States is made from stone running more than 98 per cent calcium carbonate." Appellee has converted "a large part of" to "all"—which taxpayer submits is somewhat different. In actual fact, limestones of carbonates content comparable to taxpayer's annual average are used in some areas to make lime where higher carbonates content limestone is unavailable. In California, of course, the availability of naturally occurring higher carbonates content limestone requires that to produce lime taxpayer's deposit need only be selectively quarried or sorted after quarrying into 95% limestone and limestone of lesser carbonates content. Appellee could have easily ascertained this elementary industry fact. However, the practice turns on economic feasibility—not chemical feasibility.

F. There Is No Applicable Valid Treasury Regulation.

Treasury Regulations 111, Sections 29.23(m)-5, is the so-called "end-use" test held invalid in the *Wagner Quarries* and *Virginian Limestone* cases, *supra*. Knowing this, appellee cites such Regulation to this Honorable Court (Br. p. 21) without at the same place advising of its rough handling by judicial decisions. By the same token, the Commissioner's Proposed Treasury Regulations, 24 Fed. Register, No. 28, pp. 975-976 (Br. p. 22) are irrelevant to the present issue, in clear derogation of the statute, and an attempt to arbitrarily substitute his own concept for the "chemical grade" test provided in Section 114(b)(4)(A)(iii), and are not now in effect. If they are issued, litigation will result.

G. A Depletion Allowance Having Been Granted, the Commissioner Has No Right or Power to Whittle Away What Congress Has Provided.

Appellee inaccurately characterizes the depletion allowance as "tax-free" compensation. (Br. p. 12.) None of the cited cases contain such phrase.

In the case of *Dragon Cement Company v. United States,* 244 F. 2d 513 (C. A. 1st, 1957), cert. den., 355 U. S. 833 (1957), Chief Judge Magruder accurately described the judicial function in these depletion cases, as well as the true description of the return of risk capital under depletion allowances as follows:

> "The allowance for depletion has been a controversial subject for years, and officials of the executive branch have sought from time to time, with conspicuous lack of success, to persuade the Congress to eliminate some of its alleged overgenerous

features. See Mertens, Law of Federal Income Taxation §24.04 (1954). We are not concerned with the wisdom or policy of the statutory allowance, once we are sure what the allowance is, for it is plainly our judicial function merely to apply the allowance as Congress wrote it and meant it.

"The need for and fairness of some allowance for depletion proceeds from the fact that the production of income through the exploitation of natural resources is accompanied by an inevitable consumption of capital in the form of the gradual exhaustion of the natural resources being exploited. Thus the allowance serves to offset the injustice of classifying only as income what might be regarded as income comingled with return of capital, and serves also as an incentive to encourage capital expenditures in the direction of discovery and exploitation of natural resources."

As the Supreme Court says in *Commissioner v. Southwest Explor. Co.,* 350 U. S. 308, 100 L. Ed. 347 (1956) (p. 312):

"An allowance for depletion has been recognized in our revenue laws since 1913. It is based on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit. Presently, the depletion allowance is a fixed percentage of gross income which Congress allows to be excluded; this exclusion is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted the owner's capital is unimpaired."

As the Supreme Court stated in *Helvering v. Mountain Producers Corporation,* 303 U. S. 376, 381 (1938):

". . . Congress was free to give such arbitrary allowance (percentage depletion) . . ."

Since Congress has admittedly granted the deduction, it becomes a matter of statutory construction whether the taxpayer is entitled thereto. For example, in *Lewyt Corporation v. Commissioner,* 349 U. S. 237, 99 L. Ed. 1029 (1955), the Court said (p. 240):

> "But the rule that general equitable considerations do not control the measure of deductions or tax benefits cuts both ways. It is as applicable to the Government as to the taxpayer. Congress may be strict or lavish in its allowance of deductions of tax benefits. The formula it writes may be arbitrary and harsh in its applications. But where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall. See *Bullen v. Wisconsin,* 240 U. S. 625, 630, 60 L. ed. 830, 835, 36 S. Ct. 473." (p. 240, L. Ed. p. 1033.)

Applying this settled principle to this case, as the Court stated in *Virginian Limestone Corp. v. Commissioner,* 26 T. C. 553 (1956) when construing Section 114(b)(4):

> ". . . The provisions of the statute here involved are specific and free from ambiguity. In such situation, there is no room for an interpretation, by the Commissioner or by the courts, which would vary (either upward or downward) the stated rates for specifically identified minerals, which Congress has provided."

V.
CONCLUSION.

The appellee's basic position in this case, reflected throughout its Brief, is that Congress has extended the percentage depletion too far. Thus the appellee states that the inclusion of "additives" is "unsound" (Br. p. 12) and "indefensible." (Br. p. 15.) Appellee attempts to limit and restrict taxpayer's deduction to an amount computed under the Commissioner's repudiated rules, even though a greater amount is allowable under the clear and unambiguous language of the statute. Regardless of whether or not the Commissioner likes percentage depletion or feels that Congress has extended it beyond the point that it should have, he is bound to carry out the provisions of the statute as written.

The trial court's decision on "additives" applying the simple, unambiguous rule enacted by Congress, and holding that the depletion for taxpayer's limestone is to be computed on the selling price of cement, the "commercially marketable mineral product" obtained from such limestone, is correct and should be affirmed.

Even if this Court were to accept appellee's theory that additives should be excluded, the judgment of $264,435.41 should nevertheless be affirmed, since the proper computation of such exclusion results in the identical depletion allowance found by the trial court. (As demonstrated at p. 33, *supra*.) However, should this Court decide not only that additives should be excluded, but that the method of exclusion should be the arbitrary allocation pressed by appellee, the judgment should be modified from $264,-435.41 to $249,730.50 (as computed at p. 35, *supra*), and as modified, affirmed.

The trial court's decision that taxpayer's limestone is not "chemical grade limestone" was incorrect and should be reversed, since the record shows that Congress intended such phrase to mean any limestone suitable for an industrial chemical application.

Wherefore, we pray this Court to modify the judgment and the Findings of Fact and Conclusions of Law by striking the word "not" in Finding of Fact V [R. 64] and Conclusion of Law IV [R. 70] and substituting the words and figures "fifteen (15)" for "ten (10)" in Conclusion of Law IV [R. 70], and affirming the judgment in all other respects.

Respectfully submitted,

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APPENDIX "A"

The Legislative History of "Gross Income From Mining" and Section 114(b)(4)(B)

Percentage depletion for minerals other than oil and gas was first allowed by the Revenue Act of 1932. Prior to that time, however, the Staff of the Joint Committee on Internal Revenue Taxation made a study of percentage depletion for metal mines and submitted a preliminary report to the Committee.[1] Mr. Alex R. Shepherd, mining engineer for the Joint Committee, submitted a technical report which was attached as Appendix XXXI to the Staff's report to the Committee. This Shepherd report recommended percentage depletion for metal mines computed on "gross income from the property," and discussed the meaning of this term. At page 68 Mr. Shepherd states:

> "It will be necessary to define what is meant by gross income from the property and to definitely indicate the point in accounting at which it is to be determined as well as other details. This can be done, either in the act, or interpreted in the regulations.
>
> "The consensus of opinion seems to be that the act should be written as simply as possible (as in the case of oil and gas) and the necessary definitions should be written into the regulations."

The report recommended (pp. 70-71) that the statute provide that, in the case of metal mines, the allowance for depletion be "15% of the gross income from the property," subject to a limitation of 50 per cent of

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[1]Reports to the Joint Committe on Internal Revenue Taxation from its Staff, Vol. 1, Part 8 (1929).

net income from the property. In respect to the computation of "gross income from the property," the report further states (pp. 71-72):

> "In the case of the smaller operator, the product in most all cases is sold in the crude or semi-refined (concentrate) state to smelter under contract or otherwise.
>
> "The smelting after weighing and sampling the ore or concentrate renders the seller a statement setting forth:
>
> "The gross metallic contents of the shipment.
>
> "Net metallic contents and market quotation.
>
> "Deduction for all costs, of freight, treatment, penalties, etc.
>
> "Net value in dollars and cents to seller (known as the net smelter returns) and a check in favor of seller for the product sold. Each ore shipment to the smelter is generally liquidated in the above manner.
>
> *"Therefore, in the case of 90 percent (in numbers) of the taxpayers their gross income from the property is the smelter return settlement, less royalty due lessors."* (Emphasis supplied.)

This language clearly indicates an intent to compute the depletion allowance on the selling price of the concentrates, *which are shown to be the commercially marketable products in the case of 90 per cent of the miners.*

When the depletion allowance for metal mines was added to the statute in 1932, the statutory language followed Mr. Shepherd's suggestion; that is, the statute provided a depletion allowance for metal mines computed as 15 per cent of "gross income from the property," with the definition of "gross income from the property" left to regulations.

The Bureau seems to have originally followed Mr. Shepherd's suggestions as to the computation of "gross income from the property." While the regulations did not expressly state the commercially marketable mineral product rule, they did provide for the inclusions in computing gross income, of certain enumerated processes and similar processes as well. Moreover, although there are no published rulings under these regulations showing how they were applied, the later legislative history does show what Congress was told regarding the Treasury interpretation.

The Bureau did not *originally* limit the processes includable in determining gross income from the property to those specifically listed in the regulations, but did allow many others to be included.[2] Congress was told in 1942 that the Treasury had taken the position that gross income was to be based on the first marketable product. Thus, if the mine owner sold his first marketable product, the gross income was based on the value of that product; if he applied further processes after obtaining the marketable product, an allocation had to be made.[3] But Congress was told at the same time that the Treasury had changed its position as to cinnabar ore from which mercury is obtained and was trying to exclude processes applied before the commercially marketable product was obtained.[4] A member of the Ways and Means Committee was "astonished" to learn that the Treasury was seeking to cut off the computation of the deduction for cinnabar ore before income could be realized from the ore.[5]

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[2]Hearings before the Committee on Finance on the Revenue Act of 1943, 78th Cong., 1st Sess., pp. 527-528.

[3]Hearings before the Committee on Ways and Means on Revenue Revision of 1942, 77th Cong., 2d Sess., pp. 1199, 1202.

[4]*Ibid.*

[5]*Ibid.*

When this change in practice as to cinnabar ore was brought to the attention of Congress in 1942, the Treasury urged that the matter should be handled administratively, promising that it would adhere to its *original* regulations and *procedures,* urging that Congress not act.[6] Congress in 1942 relied on this representation, but the Treasury apparently did not adhere to its original position as it said it would. In addition, in 1943 Congress was given the further information that the Treasury had been seeking since 1941 to exclude all processes not specifically listed in the regulation.[7] In the light of this situation, Congress enacted, in Section 124(c) of the Revenue Act of 1943, the statutory definition of "gross income from the property." (Sec. 114(b)(4)(B), I. R. C. 1939.)

In explaining the new provision, which originated as an amendment in the Senate Finance Committee, the Committee stated:

> "The purpose of the provision is to make certain that the *ordinary treatment processes which a mine operator would normally apply to obtain a marketable product* should be considered *as a part of the mining operation,* and to give reasonable specifications of what are to be considered such processes for various kinds or classes of mines.
>
> "The law has never contained such a definition, and *its absence has given rise to numerous disputes.*
>
> "The definition here prescribed expresses the congressional intent of these provisions as first included in the law, and is in accord with the original regulations and the Bureau practices and procedures thereunder. It is therefore made retroactive to the date

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[6] 88 Cong. Rec., Part 6, October 10, 1942, p. 8033.

[7] *Supra,* footnote 2.

of such original provisions" [Emphasis supplied]. Sen. Rep. 627, 78th Cong., 1st Sess., pp. 23-24, 1944 C. B. 991.

The logic of the purpose of this part of Section 114(b) explained above, is especially clear in view of what Congress sought to accomplish through its enactment. Congress was seeking to end numerous disputes, caused by the Treasury's attempt to whittle away at the depletion deduction. Congress wanted a simple, practical, definite rule. Certainly the rule adopted was the one best suited for that purpose, since, where there is a marketable product, the market price can easily be ascertained and used as a basis for computing the deduction.